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ABSTRACT

This audit report assesses the propriety and economy of space leasing practices of the State University of New York at Stony Brook (SUNY-SB) for the period July 1, 1994 through December 31, 1996, specifically those related to a health center that includes five professional schools, a 536-bed teaching hospital, and a 350-bed veterans' home. Some of the facilities used by SUNY-SB are owned by the state, while others are leased. Health center clinic patients are treated by faculty from the center's School of Medicine. Findings of the audit included the following: There were a number of weaknesses in 13 SUNY-SB leases related to the health center and in five leases of the School of Medicine; while officials used competitive pricing practices to compare rents, they generally did not take into account maintenance expenses, insurance costs, and property taxes; the state's economic interests were not adequately protected during renovations. Following the introduction, which covers the background, scope of the audit, objectives, and methodology, the report discusses and makes recommendations for various space leasing practices (lease costs, potential conflicts of interest, other leasing practices), maintenance expenses, and renovation costs. An appendix reports responses of SUNY officials to the audit. (MAB)

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State of New York
Office of the State Comptroller

Division of Management Audit and
State Financial Services

Report 96-S-36

Dr. John W. Ryan
Chancellor
State University of New York
State University Plaza
Albany, NY 12246

Dear Dr. Ryan:

The following is our report on the space leasing practices of the State University of New York at Stony Brook and the Clinical Practice Management Plan at the University.

The audit was performed pursuant to the State Comptroller's authority as set forth in Section 1, Article V of the State Constitution and Section 8, Article 2 of the State Finance Law. Major contributors to this report are listed in Appendix A.

Office of the State Comptroller
Division of Management Audit
and State Financial Services

May 29, 1998

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Executive Summary

State University Of New York At Stony Brook University And Clinical Practice Management Plan Space Leasing Practices

Scope of Audit

The State University of New York (SUNY) at Stony Brook (University), which offers comprehensive undergraduate and graduate programs, operates a health science center (Center) that includes five professional schools, a 536-bed teaching hospital, and a 350-bed veterans' home. The Center's hospital operates clinics in which patients are treated by faculty from the Center's School of Medicine. The amount of income earned by these faculty is regulated by the School's Clinical Practice Management Plan (Plan), and any net income from these clinical practices is to be used for the benefit of the School of Medicine. Some of the facilities used by the University and the Plan's clinical practices are owned by the State, while other facilities are leased. During the year ended March 31, 1996, 18 facilities were leased by the University at a total cost of about $3.5 million, and five facilities were leased by the Plan at a total cost of about $327,000. Most of the University's leases are made for the Center.

Our audit addressed the following question about the leasing practices of the University and the Plan during the period July 1, 1994 through December 31, 1996:

- Were these leasing practices appropriate and economic?

Audit Observations and Conclusions

We found that improvements are needed if Center and Plan leasing practices are to be as economical as possible. For example, overpayments were made on certain leases, renovation costs were not adequately controlled, and all lease costs were not considered when competitive lease proposals were evaluated. We also identified a potential conflict of interest in a lease between the Center and the Plan.

In most Center and Plan leases, the landlord's operating expenses are paid by the tenant separately from the rent and are referred to as Common Area Maintenance (CAM) charges. Such charges, which can be extensive, should be taken into account when comparisons are made among competing lease proposals. However, we found that these charges generally were not taken into account in comparisons made by Center and Plan officials, as they considered only the base rents of competing proposals. As a result, most Center and Plan leases may cost more than is necessary. (See pp. 3-6)

According to the Code of Ethics published by the State Ethics Commission, State employees should avoid making personal investments that might create a conflict of interest. However, we found that a building is leased to the Center by a realty corporation that was established and funded by the Plan. Since Plan members are faculty of the Center's School of Medicine, the lease with the Center might create a conflict of interest and therefore might violate the Code of Ethics. We believe the lease terms should be reexamined to ensure that the State's interests are adequately protected, and the lease itself should be referred to the State Ethics Commission to determine whether there is a potential conflict of interest. (See p. 6)

During 1995, six of the leases with the highest CAM charges were between the Center and a certain real estate management firm. We audited the management firm's records and determined that $35,065 of the $458,630 in claimed expenses by the firm were questionable, mainly because they had been paid more than once or were incorrectly calculated. We also found that the management firm was slow to apply $94,587 in CAM overpayments for 1995 against the next year's charges. We recommend that invalid CAM charges be refunded, all CAM charges be audited annually, and all CAM overpayments be applied promptly. (See pp. 11-14)

We further found that lease renovation costs could be better controlled, as renovation contracts were not competitively bid, renovation work was not adequately monitored, and renovation costs were not always shared with landlords. (See pp. 15-17)

Comments of SUNY Officials

Officials of SUNY Stony Brook and SUNY System Administration agree with certain of our recommendations and disagree with others. Stony Brook officials disagree with the audit conclusion that lease costs may be more than necessary.

Contents

Introduction	Background	1
	Audit Scope, Objective and Methodology	1
	Response of SUNY Officials to Audit	2
Space Leasing Practices	Lease Costs	3
	Recommendations	6
	Potential Conflict of Interest	6
	Recommendations	7
	Other Leasing Practices	8
	Recommendations	9
Maintenance Expenses		11
	Recommendations	14
Renovation Costs		15
	Recommendations	17
Appendix A	Major Contributors to This Report	
Appendix B	Response of SUNY Officials to Audit	

Introduction

Background

The State University of New York (SUNY) at Stony Brook (University) offers comprehensive undergraduate and graduate programs to 12,000 full-time undergraduate students and 3,000 full-time graduate students. Employing 1,500 full-time and part-time faculty, the University's total budget exceeds $650 million. The University operates a Health Science Center (Center), which includes five professional schools, a 536-bed teaching hospital and a 350-bed veterans' home.

Faculty at the Center's School of Medicine have both teaching and research responsibilities and may provide medical care to patients in both private practices and clinics operated by the Center. The amount of income earned by the faculty in treating patients at these clinics is regulated by the School's Clinical Practice Management Plan (Plan). According to Article XVI of the SUNY Board of Trustees' Policies, the operating expenses of Plan members' clinical practices must be deductible in accordance with IRS guidelines, while any net income from the clinical practices is to be used for the benefit of the School of Medicine. In 1995 the Plan reported operating income of $91 million and a year-end surplus of $12 million.

The University and the clinical practices regulated by the Plan generally utilize State-owned facilities and property. However, additional off-site space is required for medical clinics, office space, storage and other off-site programs. In the year ended March 31, 1996, the University expended $2.44 million to rent 18 sites, and spent more than $1.05 million on these sites for additional expenses such as property taxes, repairs and maintenance, and insurance. (The Center accounted for 13 of these leases and $3.2 million of the total lease related costs.) During that same year, the Plan leased five sites for $260,000 and incurred additional expenses of $66,000 on these sites.

Audit Scope, Objective and Methodology

We audited the University's and the Plan's space leasing practices for the period July 1, 1994 through December 31, 1996. The primary objective of our performance audit was to determine whether the University and the Plan engaged in appropriate and economic space leasing practices. To accomplish this objective, we interviewed University and Plan officials, met with officials of the Office of General Services, and reviewed University and Plan leasing files and related expenditure documentation. In addition, we interviewed officials and examined selected records of a

real estate management firm under contract to the University, and interviewed realtors in the area surrounding the University.

We conducted our audit in accordance with generally accepted government auditing standards. Such standards require that we plan and perform our audit to adequately assess those operations of the University and the Plan that are included within our audit scope. Further these standards require that we understand the University's and the Plan's internal control structure and their compliance with those laws and regulations that are relevant to the operations that are included in our audit scope. An audit includes examining, on a test basis, evidence supporting transactions recorded in the accounting and operating records and applying such other auditing procedures as we consider necessary in the circumstances. An audit also includes assessing the estimates, judgments and decisions made by management. We believe that our audit provides a reasonable basis for our findings, conclusions and recommendations.

We use a risk based approach to select activities for audit. Therefore, we focus our audit efforts on those activities that have been identified through our preliminary survey as having the greatest probability for needing improvement. Consequently, by design, finite audit resources are used to identify where and how improvements can be made. Thus, we devote little audit effort to reviewing operations that may be relatively efficient and effective. As a result, our audit reports are prepared on an "exception basis." This report, therefore, highlights those areas needing improvement and does not address activities that may be functioning properly.

Response of SUNY Officials to Audit

A draft copy of this report was provided to SUNY officials for their review and comment. Their comments have been considered in preparing this report and are included in Appendix B.

Within 90 days after final release of this report, as required by Section 170 of the Executive Law, the Chancellor of the State University of New York shall report to the Governor, the State Comptroller, and the leaders of the Legislature and fiscal committees, advising what steps were taken to implement the recommendations contained herein, and where recommendations were not implemented, the reasons therefor.

Space Leasing Practices

We identified no significant weaknesses in the five University leases not related to the Center. However, we identified a number of weaknesses in the 13 University leases related to the Center and in the five leases of the Plan. We conclude that improvements are needed if the leasing practices of the Center and the Plan are to be as economical as possible. We also identified a potential conflict of interest in a lease between the Center and the Plan.

Lease Costs

If lease costs are to be as low as possible, considering space needs, comparisons must be made among different available leases. In some lease agreements, the rent payment is intended to cover all the landlord's operating expenses, including all maintenance expenses, insurance costs and property taxes. However, in other lease agreements, these expenses are paid by the tenant separately from the rent and are referred to as Common Area Maintenance (CAMs). When comparing the costliness of different leases, it is important to compare the total cost involved in each lease, including any CAMs.

We examined the procedures used by the Center and the Plan in selecting leases. We found that, when selecting a lease, officials use competitive pricing practices to compare the rents in different available leases. However, the officials generally do not take CAMs into account when comparing different leases. In one instance, Center officials did take CAMs into account, as they solicited competitive bids, analyzed all the costs involved in each proposed lease, and selected the lease with the lowest total cost over the life of the lease.

However, in the other Center and Plan leases we reviewed, Center and Plan officials selected a lease after comparing only the base rents in the different proposed leases; if a proposed lease had CAMs (and most Center and Plan leases do have CAMs), the CAMs were not taken into account in the officials' analysis. As a result, most Center and Plan leases may cost more than is necessary.

For example, in 1994 the Center renegotiated five of its leases. According to records maintained by the Center, compared to the other competitive bids, the leases selected by Center officials had the lowest available base rents per square foot for medical and office space. However, when we contacted the realtors who made some of the competing bids, we were told

that Center officials had compared "apples to oranges" because many of the expenses covered by the CAMs in the five leases that were selected were already included in the base rents of competing leases that were not selected. As shown in the following table, the total cost of the five leases is greatly increased by their CAMs:

Lease Number	Base Rent/ sq. ft.	Annual Rent (1)	CAM/ sq. ft.	Annual CAM	Total Cost
L-000583	$16.53	$ 266,216	$ 9.24	$148,810	$415,026
L-000631	$23.35	$ 264,999	$ 8.24	$ 93,516	$358,515
L-000630	$16.53	$ 113,908	$11.12	$ 76,634	$190,542
L-000632	$16.53	$ 157,564	$11.12	$106,003	$263,567
L-000485	$12.75	$ 371,025	$ 7.64	$222,400	$593,425
Total		$1,173,712		$647,363	

(1) Includes medical and office space, but does not include storage space.

Response of Stony Brook Officials to Audit: In responding to this report, Stony Brook officials stated that the data presented do not support the conclusion that leases may cost more than is necessary. Officials further stated that the table of expenses is not reflective of conditions that existed in 1993 when the lease negotiations began and, therefore, could be misinterpreted. Officials pointed out that the expenses in the table include one-time sewer fees and real estate taxes based upon sewer installations which were not a factor in 1993.

Auditor Comments: The analysis presented in the audit is intended to show the potential effect of Center practices of not including CAM costs in documented analyzes used to make leasing decisions. The CAM costs in the table not only include sewer costs but also include other operating expense items such as snow and rubbish removal, management fees, repairs and maintenance, and landscaping costs commonly associated with site operations. We believe that these conditions justify concluding that lease costs may be more than is necessary.

Moreover, these five leases do not limit the financial liability of the Center, as under the terms of the leases, the Center is liable for all expenses incurred by the landlord, and was billed for such expenses as building insurance, roof replacement, and legal fees to defend the landlord against a lawsuit involving the property. According to officials in the Bureau of Leases of the New York State Office of General Services (OGS), many of the CAM expenses paid by the Center are normally borne by the landlord as a cost of doing business and, if not, the base rent should be reduced accordingly. We therefore conclude that the costs incurred by the Center for these five leases are probably more than is necessary.

Contracts, including lease agreements, exceeding $10,000 a year must be approved by the Office of the State Comptroller. When such agreements are submitted for approval, they should be accompanied by evidence of competitive price comparisons. Such evidence provides assurance that the lease prices are not unreasonably high. For the leases that were in effect during our audit period, we examined the evidence of competitive price comparisons that was submitted by the Center along with the leases to the Office of the State Comptroller. We found that, generally, these pricing comparisons contained only the cost per square foot for the base rent, and did not include any CAMs. As a result, the information provided to the Office of the State Comptroller did not accurately represent the full cost differences between the competing proposals.

Center officials told us that cost is not the only criteria they consider when they select a lease, and the leases they selected also met other important criteria, such as accessibility, appearance, and proximity to the Center. We acknowledge that criteria other than cost are important and that, according to records maintained by the Center, these other criteria were considered by Center officials when the Center's leases were selected. However, because the various criteria were not weighted by Center officials, the relative importance of criteria other than cost cannot be determined. Center officials also told us that the leases we question were approved by SUNY System Administration, the Attorney General's Office, and the Office of the State Comptroller. However, as has been explained, the Center generally did not disclose CAMs when documenting lease agreements.

Recommendations

1. When comparing the costs of different leases, take into account all lease costs, including CAMs, and submit evidence of this comparison to the Office of the State Comptroller when the lease is submitted for approval.

2. Develop guidelines for weighting the criteria used in selecting leases.

(Officials of Stony Brook and SUNY System Administration generally agree with recommendations 1 and 2.)

Potential Conflict of Interest

The State Ethics Commission has published a Code of Ethics that applies to all New York State employees. According to the Code of Ethics, State employees should avoid making personal investments in enterprises that might create a conflict of interest. However, we found that a building is leased to the Center by a realty corporation that was established by the Plan In purchasing the building, the realty corporation used Plan funds that were advanced at no interest. Since Plan members are faculty of the Center's School of Medicine, the lease with the Center might create a conflict of interest. Since Plan members are also State employees, the lease may violate the Code of Ethics.

The building, which was purchased by the realty corporation in 1993 for $525,000, is leased to the Center for more than $300,000 annually (at a cost of $17.65 per square foot) plus annual CAM charges in excess of $100,000. In addition, more than $600,000 has been paid by the Center to renovate the building. We believe this arrangement is favorable to the Plan.

Because this lease is not an arm's length transaction, we believe the lease terms should be reexamined to ensure that the State's interests are adequately protected. To ensure that the State's interests are adequately protected, we believe the terms of any lease between the Center and the Plan should be governed by appropriate guidelines; we believe a model for such guidelines can be found in the New York State Office of Alcoholism and Substance Abuse Services' (OASAS) Bulletin 96-05, which addresses the leases between OASAS contractors and realty companies owned by the contractors. According to the Bulletin, the cost of such leases should be restricted to the lesser of the actual cost to the landlord or the fair market value of the transactions.

Recommendations

3. Refer the lease between the Center and the Plan to the State Ethics Commission to determine whether the lease violates the Commission's Code of Ethics.

   (Stony Brook officials responded that they do not believe a referral to the Ethics Commission is necessary because at the time the lease was made in August 1995, the University was not aware of a possible ethics violation. They added that SUNY Administrative Procedures were subsequently revised in April 1996 to require inquiries relating to ownership and to determine if competitive bidding is required. Officials agreed to adhere to this policy in the future. SUNY System Administration officials similarly responded that the 1996 revisions to its Administrative Procedures would govern any new leases or extensions to existing leases.)

   Auditor Comments: The responses of Stony Brook and System Administration officials overlook the possibility that a violation of the New York State Code of Ethics may have occurred and that this needs to be investigated regardless of the timing of revisions to SUNY Administrative Procedures.

4. Develop guidelines consistent with OASAS Bulletin 96-05 that govern leases between the Center and Plan, and renegotiate the lease between the Center and the Plan in accordance with the guidelines.

   (Stony Brook and SUNY System Administration officials responded that a retrospective review of the lease is not necessary and that existing procedures provide adequate assurances. They added that all leasing transactions are examined prior to their execution and only those that are in the best interest of the campus are approved.)

   Auditor Comments: We continue to maintain that the lease should be reexamined because of its potential less than arms length nature. In addition, we continue to believe that the recommended guidelines would be beneficial for controlling lease costs.

Other Leasing Practices

In April 1996, the Plan began a five-year lease for a primary care medical facility and general office space in Patchogue. However, we found that, as of December 31, 1996, the Plan had yet to make use of the leased space. The Plan was to pay rent of $14,079 in the first year of the lease, and rent of $29,491 in the second year of the lease. In addition, according to Plan officials, the Plan has paid an additional $248,000 to renovate the space. Plan officials told us they intended to begin making use of this space in January 1997. Since any net income generated by the Plan is distributed to the Center's School of Medicine, the loss incurred by the Plan on this empty space represents lost revenue to the Center, and therefore lost revenue to the State.

Response of Stony Brook Officials to Audit: Stony Brook officials responded that funds were used for a strategic business decision to address educational needs of medical residents, the primary care needs of the surrounding communities, and to increase the Center's presence, revenues and hospital referrals in these communities. They added that occupancy of the space was delayed due to unanticipated facuity vacancies in the primary care departments slated to operate the space.

Auditor Comment: It is not clear whether making $126,000 of lease payments and spending $248,000 on renovations is prudent when the space would be unused for at least nine months.

The Plan contains 18 professional medical service corporations that generally treat patients in facilities operated by the Center. For these purposes, the Center and the Plan have entered into memoranda of agreement, which describe the arrangements between the Center and the Plan. In accordance with certain of these memoranda of agreement, the Plan reimburses the Center for space, Center staff and other services used by the medical service corporations. In 1995, these reimbursements exceeded $3 million. According to Section 112 of the State Finance Law, all contracts for more than $10,000 must be approved by the Office of the State Comptroller and the Attorney General. However, we found that none of these memoranda of agreement have been submitted to Office of the State Comptroller or Attorney General for approval. We note that, at the SUNY Health Science Center at Syracuse, all such agreements have been approved by the Office of the State Comptroller and the Attorney General.

In response our preliminary findings, Center officials stated that it was their opinion that these agreements do not constitute contracts since they lack the five elements of a contract and that like entities (Plan/Hospital) can not enter into contracts with themselves.

Recommendations

5. Promptly either make use of the space in Patchogue, sublet the space, or terminate the lease.

   (Stony Brook officials responded that the space in Patchogue is currently occupied and being utilized to train residents.)

6. Submit to the Office of the State Comptroller and the Attorney General all agreements between the Center and the Plan's professional medical service corporations.

   (Stony Brook officials did not respond directly to this recommendation instead citing the requirements of Article XVI of the Policies of the Board of Trustees with respect to the Plan for the Management of Clinical Practice Income. SUNY System Administration officials responded that they would review these relationships and submit future agreements with professional service corporations in accordance with section 112 of the State Finance Law, if required.)

   Auditor Comments: The Office of the State Comptroller's Counsel's Office has reviewed these agreements and concluded that they are contracts and, as such, must conform to the normal contract review process. The SUNY Health Science Center at Syracuse is submitting its agreements between its Plan entities and its hospital to the State Comptroller's Office and the Attorney General's Office for review.

Maintenance Expenses

Most Center and Plan leases require CAM payments in addition to rent payments. During 1995, six of the leases with the highest CAM payments were between the Center and the same real estate management firm. In each of these leases, the Center was required to pay rent, the landlord's actual expenses in maintaining the property, and a fee to the real estate management firm. The six leases began between 1988 and 1995, and during 1995, the CAM payments for the six leases (including the management firm's fees) totaled $458,630.

In order to determine whether the $458,630 in CAM payments was appropriate, we audited the management firm's expense records for the 1995 calendar year. We found that some of the CAM payments were not appropriate, as duplicate payments were made by the Center, the management firm's fees were incorrectly calculated, payments were made to a reserve account that was never used, and certain payments made by the Center were not applied against landlord expenses. In total, we question the appropriateness of $35,065 of the $458,630 in CAM payments. Following are examples of some of the questioned payments:

- The Center made a number of duplicate payments for the same expense. In some instances, the Center was double billed by the management firm because an expense was included in more than one category in the firm's records. In other instances, the Center made duplicate payments because an expense was included in a CAM category and was also paid for separately as a repair. Some expenses were paid for three times.

- In four of the six leases, the Center was overcharged a total of $13,915 because the management firm's fees were incorrectly calculated.

- In two of the leases, the Center was charged a total of $3,218 for a capital reserve account. However, according to officials at the management firm, the Center is required by the leases to make specific payments for specific capital improvements, and the capital reserve account is not used for such purposes. For example, in 1996 the Center budgeted $37,000 for specific capital improvements. Neither management firm officials nor Center officials were able to tell us the balance in this capital reserve account. We

therefore question the $3,218 charged to the account for 1995, and recommend that the Center determine the amount paid into the account and receive a full refund of this amount.

- In one of the six leases, $3,012 in payments made by the Center to the management firm for parking spaces were not applied against CAM expenses, as was provided for in the 1995 budget for the lease.

Response of Stony Brook Officials to Audit: Stony Brook officials responded that the landlord has passed a proportionate share of the parking lot income on to the hospital because the assigned condominium charges were at a reduced rate reflecting the income.

Auditor Comments: We had inquired during the audit about any parking revenue offsets, but none were confirmed. If the described procedure is being followed, it would seem to address the concern for offsetting this expense.

We also found that, in five of the six leases, the Center was charged in 1995 for anticipated real estate taxes. The tax charges, which totaled $61,133, related to expected assessments for sewer lines built by the Town of Brookhaven. An official of the management firm told us that when the actual tax bill was received, it covered both 1995 and 1996, and significantly exceeded the $61,133 that was billed to the Center for 1995. The official further stated that the balance of the unpaid taxes exceeds the $35,065 in other expenses that we question. We recommend that Center officials review the tax bill, determine the portion of the bill relating to 1995, apply the $35,065 in questioned costs against any unreimbursed taxes, and ensure that the portion of the bill relating to 1996 is correctly paid. We also recommend that the Center annually audit the CAM expenses claimed in its leasing agreements.

Each year the real estate management firm prepares a budget for each of the six leases. On the basis of these budgets, the management firm calculates the Center's total estimated CAM expenses for the year and bills the Center for these expenses quarterly. At the end of the year, the management firm reconciles the CAM payments received against the actual CAM expenses, and either bills the Center for the shortfall or applies the overpayment against future CAM expenses.

The CAM payments made by the Center for 1995 exceeded the CAM expenses that were reportedly incurred by a total of $94,587. As a result, the management firm was to apply this overpayment against future CAM expenses. However, we found that the overpayment was not applied against the budgeted CAM expenses that were billed to the Center for the first and second quarters of 1996, and only half the overpayment was applied against the budgeted CAM expenses that were billed for the third and fourth quarters of 1996. While the balance of the overpayment may be applied against the budgeted CAM expenses for 1997, mistakes are more likely when such adjustments are delayed for so long. In addition, when such a long time is taken to refund an overpayment, the Center is denied access to its own money for more than a year.

We also note that, according to the terms of one of the leases, the Center is to be charged a management fee by a condominium association that is controlled by the real estate management firm. Since the Center is also charged a management fee by the real estate management firm for this lease, we question whether the two management fees are, to some extent, duplicative. We recommend that Center officials investigate this matter and determine what services are covered by the two sets of fees.

Recommendations

7. Ensure that the Center conducts annual audits of all CAM expenses.

8. Determine the portion of the sewer tax bill relating to 1995 and reconcile this amount against the $61,133 that was already paid in 1995. If there is an unpaid tax balance for 1995, apply the $35,065 in questioned costs against this balance, and obtain a refund for any questioned costs in excess of this balance. When paying the sewer taxes for 1996, ensure that payments made for 1995 are not duplicated.

9. Ensure that the fee charged by the real estate management firm is correctly calculated.

   (Stony Brook and SUNY System Administration officials generally agreed with recommendations 7, 8, and 9.)

10. Determine the amount paid into the capital reserve account and obtain a refund of this amount.

    (Stony Brook and SUNY System Administration officials disagree with this recommendation. They maintain that the charge was correctly applied and does not belong to either the property management firm or the landlord. They added that the condominium association controls its own budget including the capital reserve account line item, the costs of which are proportioned among the condominium owners.

    Auditor Comments: Stony Brook officials should require the association to disclose the plans for the use of this fund and determine how this benefits its tenancy. This is especially important since Stony Brook is already paying for capital improvements on an ongoing basis.

11. Require the entire amount of any CAM overpayment to be applied against the next quarterly billing after the overpayment has been identified.

12. Determine whether the management fees paid to the condominium association and the real estate management firm are at all duplicative, and if so, work to eliminate the duplication.

    (Stony Brook and SUNY System Administration officials agree with recommendations 11 and 12.)

Renovation Costs

Between 1991 and 1996, the Center spent more than $1.3 million, and the Plan spent more than $900,000, to renovate leased space. If such renovation costs are to be adequately controlled, actions concerning the renovations should be guided by written procedures that protect the State's economic interests. For example, written procedures should describe (1) how the contractor performing the renovations is to be selected, (2) how the estimate of the renovation costs is to be developed and documented, (3) how actual renovation costs, as well as the renovation work itself, should be monitored and approved, and (4) how renovation costs should be shared by the landlord and the tenant. However, we found that neither the Center nor the Plan has written procedures relating to the renovation of leased space. As a result, the State's economic interests are less likely to be protected when space leased by the Center or the Plan is renovated.

We reviewed two Center leases with renovations and two Plan leases with renovations with the largest dollar value, to determine whether the State's economic interests were adequately protected in the renovation work. We found that the State's economic interests were not adequately protected, as follows:

- Competitive bidding helps to provide assurance that the price obtained for a service is fair and reasonable. However, Center officials told us they do not require landlords to obtain competitive bids for renovation projects, and we found no indication competitive bidding was used in the renovations done at space leased by the Plan. In one of the Center leases we reviewed, the renovations were done by a construction firm that was owned by the landlord. In the absence of competitive bidding, renovation costs are more likely to be higher than necessary.

- It is important to have a reliable estimate of cost when performing a renovation project, as a reliable estimate can help provide the basis for accepting or rejecting proposed renovations, and can be used to monitor the appropriateness of actual costs. However, we found that cost estimates were not developed for the renovation projects we reviewed. As a result, Center and Plan officials were less able to effectively evaluate the reasonableness of renovation costs.

- To help ensure that renovation costs are reasonable, the renovation work should be monitored. The leases allowed the Center to hire a professional representative to monitor the renovation work at the leased space. However, we found that a representative was not hired for one of these two Center leases. While a representative was hired for the one lease, the representative told us that he did not evaluate the appropriateness of the costs charged, as he ensured only that the renovation work complied with building codes.

- According to officials from OGS, a landlord can reasonably be expected to pay some of the costs involved in renovating a site, and in the two Center leases we reviewed, the landlord was required to pay for all renovations up to $30 per square foot of renovated space (such a provision in a lease is called a build-out allowance). However, in both of the Plan leases we reviewed, the landlord was not required to pay for any of the renovation costs, and the entire $796,000 in renovation costs for the two leases was paid by the Plan. We also note that in the two Center leases, the Center was responsible for all renovation costs over $30 per square foot, without limit. We believe the tenant's responsibility for such costs should be subject to some limit.

Contracts, including lease agreements, exceeding $10,000 a year must be approved by the Office of the State Comptroller, and when such agreements are submitted for approval, they should be accompanied by evidence of competitive price comparisons. We found that the price comparisons submitted by the Center do not reveal total renovation costs. Because the price comparisons are not complete, they do not show which leases are most economical for the State.

When the leases negotiated by OGS include renovation costs, the leases are reviewed by the OGS Bureau of Project Coordination, which must ensure that the renovation costs are reasonable before the leases can be approved. We spoke with OGS officials, and they told us that their staff are willing to advise State agencies on the reasonableness of proposed renovation costs. We recommend that Center and Plan officials make use of the advisory services offered by OGS.

Center officials generally agree with our conclusions and recommendations concerning lease renovation costs, and told us, "we accept your recommendations as guidelines for future arrangements and will make every reasonable effort to comply with them."

Recommendations

13. Develop written procedures for lease renovations and ensure that these procedures protect the State's economic interests in the areas of contractor selection, cost estimation, cost monitoring, and cost sharing with the landlord.

14. Indicate how renovations will be paid for in the price comparisons that accompany the leases submitted for the approval of the Office of the State Comptroller.

15. Consult with OGS on an ongoing basis as to the reasonableness of proposed lease renovation costs.

(Stony Brook and SUNY System Administration officials agree with recommendations 13,14, and 15.)

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Appendix A

50 YEARS SERVICE, PRIDE & EXCELLENCE

STATE UNIVERSITY OF NEW YORK

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Niagara County
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Onondaga
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Rockland
Schenectady County
Suffolk County
Sullivan County
Tompkins Cortland
Ulster County
Westchester

February 11, 1998

Mr. Jerry Barber
Audit Director
Office of the State Comptroller
The State Office Building
Albany, New York 12236

Dear Mr. Barber:

In accordance with Section 170 of the Executive Law, we are enclosing the comments of State University of New York at Stony Brook and SUNY System Administration regarding the draft audit report on University and Clinical Practice Management Plan Space Leasing Practices, State University of New York at Stony Brook (96-S-36).

Sincerely,

Donald G. Dunn

Donald G. Dunn
Executive Vice Chancellor

Enc.

Appendix B

State University of New York
University at Stony Brook

University and Clinical Practice Management
Plan Space Leasing Practices

Space Leasing Practices

(SUNYSB) When the need for off-site space is identified, committees comprised of many disciplines from the Medical Center are formed to ensure that the process for leasing real property outlined by SUNY Capital Facility Management and the Office of the State Comptroller (OSC) is followed. The committee identifies selection criteria based on the needs of the department(s) to be relocated, visits prospective sites, analyzes the competition, and makes recommendations based on the site that best meets the established criteria. Many criteria are used in the selection of space including cost, availability, accessibility, proximity to the Hospital, appearance, design, availability of ample parking, expansion possibilities, size, adjacent storage space at a substantially lower cost, ability to hook up to existing communication systems without the need for recurring charges, ability to use pre-existing transport systems for patients, staff, records, and supplies and equipment, and the ability to use pre-existing contracts for pick-up and transport of biohazardous waste. Internal controls over the lease award process are adequate to insure full compliance with prescribed procedural guidelines to ensure that the most economical lease terms are obtained.

Successful bidders are determined by their ability to meet a majority of the specifications at a rental rate that is in the range of current market value, with preference to the site at the lowest rate. In all cases the Hospital's recommendation, and the subsequent approval by SUNY System Administration, the Attorney General, and the State Comptroller, went to the lowest qualified site.

Lease Costs (Pg. 3)

(SUNYSB) The Comptroller's staff have concluded "most [Health Sciences] Center and Plan leases may cost more than is necessary". The data presented do not support this conclusion with respect to either the Hospital or the Plan leases reviewed. The conclusion is based on non-binding price quotations obtained through after-the-fact contact with area realtors and comparison of Hospital leases with other leases that are incompatible for a variety of reasons. The following information is provided in order to clarify issues that either have not been included in the Comptroller's presentation or have been presented in an incomplete manner that could lead to misinterpretation.

Common Area Maintenance (CAM) Costs: The table of Rent and CAM expenses presented under this heading, included by the Comptroller's staff to "illustrate how

CAM charges added to the total cost of the lease", is not representative of conditions in 1993, when the negotiations began and could be misinterpreted. The expenses listed in the table are for fiscal year 95/96 and include one-time sewer fees and real estate taxes based upon sewer installations. Sewer expenses were not a factor in 1993. The cost comparisons made in the table are therefore not valid.

"Gross" versus "Net" Leases: The Comptroller's staff "find the overall lease terms and conditions more favorable in the OGS (Office of General Services) lease" than in the Hospital's lease in the building they both occupy, mostly because the OGS negotiated lease is a "gross" lease and the Hospital's lease is a "net" lease. This is an oversimplification of a rather complicated matter. The Comptroller's staff has not accounted for factors other than the type of lease that have caused differences in cost or the fact that a even a "gross" lease may not include all significant expenses. All leases submitted to and approved by the State Comptroller, Attorney General and SUNY System Administration were triple net leases. None of these offices ever questioned the use of a triple net lease or suggested that OGS be involved in the lease negotiations.

1. Type of Space - The Comptroller's comparison of the OGS lease to the Hospital's lease does not consider the different uses/classifications of the two spaces being leased. The space leased by OGS is classified as Research and Development (R&D) and is therefore not comparable to medical space. Land costs for R&D space are half that of medical space because building codes require twice as much acreage to build a medical building as for the same size R&D building, largely due to wastewater discharge requirement. Medical space interiors account for 30-40% of the total costs of building the space, whereas in R&D space, interiors account for about 15%. Interior R&D space costs $2.50-$5 less per square foot to outfit than medical space. The R&D portion of the building is a relatively open, basic floor plan with low-end finishes, not designed to attract and maintain patients or a managed care contract base. Medical space also typically has a much more intense plumbing design and much more people using the plumbing facilities because it is not only occupied on a daily basis by its employees, but by the constant stream of patients and their escorts.

Note

These cost differences imply a market for R&D space of $11 per square foot per year (NNN), which is $6-$7 per square foot per year less than the market for medical space ($17-$18 NNN). The differences in land and interior costs and not gross versus net, are the factors responsible for the variances in the lease rates.

2. Market Factors - The market conditions at the time that the two contracts were negotiated were not comparable. OGS negotiated their lease in 1992, in a buyers' market. The Hospital negotiated its lease in 1995, in a seller's market.

3. Level of Services - In a triple net lease the tenant determines the extent of the

See State Comptroller's Note 1, Appendix B-11

services required and the landlord arranges for the line items to support the tenant needs. In a gross lease, the landlord completely manages the expenses and the provision of services and is only required to provide a minimum of services. The less service provided, the greater the landlord's return on investment. The Hospital is operating a medical facility with strict operating requirements that is attempting to gain its share of a very competitive managed care market. It therefore needs to have complete control of the building environment and cannot risk reductions in service quality. The existing "net" leases provide the Hospital with the necessary level of control over service quality.

In 1994, after two years of discussion, analysis and negotiation, five Hospital leases were renegotiated in an effort to reduce costs in recognition of the change in market value in the surrounding area. The negotiations were successful, and resulted in savings of over $8 million dollars over the term of the leases while also providing for upgrades to the physical environment at each building at the landlord's expense, including: new carpet, new wallpaper, paint, handicap accessible entrance doors, glass enclosures at reception desks, HVAC upgrades, improved outdoor lighting, a new children's waiting area, and improved drainage around the pool. All of the resulting amendments to the leases were approved by SUNY System Administration, the Attorney General, and the State Comptroller.

The Comptroller's staff, after interviewing local realtors approximately two years after these negotiations were completed, are of the opinion that there would have been CAM cost savings if the Hospital had negotiated a gross lease with a competitor. None of the other sites contacted during the time of the negotiations offered lease terms that met the Hospital's specifications or that would have turned out to be significantly less expensive when all relevant factors were considered. The after-the-fact quotes from realtors the Comptroller's staff refer to cannot be relied on because they are non-binding, made at a different time, under completely different circumstances and without the ability to make a valid comparison. In addition, the Comptroller's staff have not considered the Hospital's need for control over the building environment and the other criteria that were factored into the Hospital's decision discussed above.

If the objective was to reach a conclusion concerning the reasonableness of the cost of these leases, the Comptroller's staff could have attempted to review comparable leases (i.e., leases for medical space for a similar term that were entered into at approximately the same time and still in force).

Recommendations (Pg. 6)

(OSC) 1. When comparing the costs of different leases, take into account all lease costs, including CAMs, and submit evidence of this comparison to the Office of the State Comptroller when the lease is submitted for approval.

(OSC) 2. Develop guidelines for weighting the criteria used in selecting leases.

(SUNYSB) 1-2. We agree that all quantifiable costs should be considered along with the other defined selection criteria when analyzing bids for leases and we believe we have adequately analyzed and disclosed those costs and criteria to the Office of the State Comptroller. We agree with the usefulness of increased formality in the weighting of decision factors and plan to develop a more formal weighting system that reflects the operating and financial needs of the Center to be used in analyzing future leasing decisions.

(SU) 1-2. We agree with the recommendations and the Campus' responses.

Potential Conflict of Interest (Pg. 6)

Recommendations (Pg.7)

(OSC) 3. Refer the lease between the Center and the Plan to the State Ethics Commission to determine whether the lease violates the Commission's Code of Ethics.

(SUNYSB) 3. We do not believe that a referral to the Ethics Commission is necessary. At the time this lease was negotiated, executed and approved (August, 1995), the University was not aware that a possible ethics violation existed. The SUNY Administrative procedures were subsequently revised in April, 1996 to impose a requirement that the University make specific inquiries relating to ownership in order to determine whether competitive bidding is required. The University will conform its procedures to the revised SUNY procedures in the future.

We also note that during the discussion of the preliminary audit findings in early 1997, the Comptroller's staff specifically focused on the issue of whether an ethics question existed in the context of the leasing transactions they had examined. They informed campus officials that in the course of their audit they found no evidence of a violation of the Ethics Law.

(SU) 3. The University is aware of the conflict of interest standards of the Public Officers Law and has already addressed the issue of requirements for competitive bidding when agreements are entered into between the University and its employees through a 1996 amendment to the Administrative Procedure Manual. Any extensions to such leases, as well as any new leases, will be governed by that requirement.

(OSC) 4. Develop guidelines consistent with OASAS Bulletin 96-05 that govern leases between the Center and Plan, and renegotiate the lease between the Center

and the Plan in accordance with the guidelines.

(SUNYSB) 4. A retrospective review/renegotiation of this lease is not necessary. We believe existing procedures already provide the campus with the necessary assurances. All leasing transactions are examined prior to their execution and only those that are in the best interest of the campus are approved.

(SU) 4. We agree with the Campus' response.

Other Leasing Practices (Pg. 7)

Recommendations (Pg. 8)

(OSC) 5. Promptly either make use of the space in Patchogue, sublet the space, or terminate the lease.

(SUNYSB) 5. The space in Patchogue is currently occupied and being utilized in order to fulfill the requirement to train residents in an outpatient setting as well as to allow clinical faculty in Family Medicine and Pediatrics to provide revenue-generated outpatient care in the communities surrounding the Medical Center. The Comptroller's draft erroneously concludes that funds were spent needlessly on the Patchogue space. Medical Center management made a strategic business decision to address the educational needs of medical residents and the primary care needs of the surrounding communities and to increase the Center's presence, revenues and hospital referrals in these communities. This decision was in the best interests of the Medical Center and leasing space in Patchogue was necessary to implement it. Occupancy of the space was delayed due to unanticipated faculty vacancies in the primary care departments (Family Medicine and Pediatrics) slated to operate in the space.

(OSC) 6. Submit to the Office of the State Comptroller and the Attorney General all agreements between the Center and the Plan's professional medical service corporations.

(SUNYSB) 6. Article XVI of the Policies of the Board of Trustees (Article XVI) establishes the Plan for the Management of Clinical Practice Income and the rules by which it is governed. Its provisions are collectively negotiated between the State of New York and United University Professions (UUP). Section 4(g)(2) states that reimbursement to the State for the cost of clinical practice will be made pursuant to a "formula established by the chief administrative officer [defined by the Trustees as the campus president] in consultation with the governing board of the practice plan and approved by the Chancellor in consultation with the Governor's Office of Employees Relations." The

5

* Note

University calculates the amount of reimbursement for the cost of clinical practice as part of its budgetary process. The University is committed to complying with the provisions of Article XVI.

(SU) 5-6. The University will review these relationships and submit future agreements with professional service corporations in accordance with section 112 of the State Finance Law, if required.

Maintenance Expenses

(SUNYSB) The Comptroller's staff question a number of costs that are included in the "common area maintenance" charges (CAM's) assessed by the landlord under the terms of the various leases. The following information is provided in order to clarify issues that have not been included in the Comptroller's presentation:

Capital Reserve Account and Management Fees - See response to Recommendations 9 and 10.

Payments for Parking Space - The Comptroller's staff states that payments made by the Hospital to the management firm for parking spaces were not applied against CAM expenses. As stated in our response to the preliminary findings, the Hospital does not make a specific payment to the landlord at L00485 for the parking spaces. The landlord provides the spaces as part of the base rent paid by the Hospital. The landlord leases the spaces from the condominium association that operates an adjacent property. The payments from the landlord (L000485) to the condominium association are properly treated as income to the condominium and applied against its operating budget. The cost of this budget is apportioned among the owners of the suites that make up the condominium, benefitting all the owners and reducing their share of the costs.

In leases L000630 and L000632 the Hospital rents space owned by one of several owners in the condominium. The landlord for these leases, a part owner in the condominium, bills the Hospital under terms of the lease for the reduced condominium charges, thus passing its proportionate share of the parking lot income on to the Hospital. The landlord is not entitled to pass along a full credit for the parking lot income to its tenant, only its proportionate share.

Timing of CAM Payments - The Comptroller's staff questions the fact that the Center was charged for real estate taxes before they were paid by the management firm. As stated in our response to the preliminary audit findings, the property management firm has been invoicing the State, on behalf of the respective landlords, for quarterly CAM charges in accordance with the terms of the respective lease that was approved by the State Comptroller and Attorney General. The leases clearly state that the CAM expense are to paid in advance based on an estimated twelve

month period. CAM expenses are paid in advance based on estimated costs which are invoiced quarterly and reconciled annually, on or about April 1st of each year.

Recommendations (Pg. 11)

(OSC) 7. Ensure that the Center conducts annual audits of all CAM expenses.

(SUNYSB) 7. As with all Hospital expenses, each and every invoice is reviewed by Hospital and campus personnel prior to authorizing payment. The annual CAM expenditure reconciliations and monthly and quarterly invoices are thoroughly reviewed for reasonableness and fairness on multiple levels, using historical information as a guide. In addition, all CAM payments are reviewed and approved by the Office of the State Comptroller. Inconsistencies found during the review process are researched and explained, and in all instances where inquiries came from the Comptroller's Office, the matter was satisfied and payment was made, a further indication of the appropriateness of the expense.

The appropriate means for monitoring CAM expenses is a review by Hospital staff, consisting of inquiry and analytical procedures to ensure consistency and reasonableness of data. We have requested that the property management firm provide detailed annual CAM expenditure reconciliation worksheets by expense class, itemizing each work order number and amount paid to enable more thorough and complete review and analysis by Hospital staff. Formal audits may be conducted, on a periodic basis, to provide assurance as to the adequacy of the review process and procedures for CAM expenditures depending upon the relative risks involved in these transactions when compared with other Hospital activities.

(OSC) 8. Determine the portion of the sewer tax bill relating to 1995 and reconcile this amount against the $61,133 that was already paid in 1995. If there is an unpaid tax balance for 1995, apply the $35,065 in questioned costs against this balance, and obtain a refund for any questioned costs in excess of this balance. When paying the sewer taxes for 1996, ensure that payments made for 1995 are not duplicated.

(SUNYSB) 8. In December 1996 while the Comptroller's staff were on site, the sewer tax assessment was billed by the Town of Brookhaven and paid by the property management firm.

(OSC) 9. Ensure that the fee charged by the real estate management firm is correctly calculated.

(SUNYSB) 9. The management fees have been recalculated. The property management

firm owes the Hospital $1,480. [$6,980 for L000631 + $6,605 for L000485 + ($1,246) for L010256 + ($10,859) for L000630, L000632].

The management fees on L000485, L000583, and L000631 were incorrectly calculated on gross revenue instead of net rent, and credits of $13,585 will be applied (1.235% of the $1.1 million dollars in CAM expenditures referenced by OSC).

Management fees for L010265, however, are based on "four per cent (4%) per annum of the gross revenues of the building". Recalculations based on gross revenue reveal that the Hospital owes the property management firm a net amount of $1,246.

Management fees at L000630 and L000632 were recalculated to correctly include the Hospital's proportionate share of condominium charges for the property management of common areas, as per Paragraph 9 of L000630 and L000632 and Paragraph 8 of the 3rd Amendment to L000630 and L000632, a sum of $15,579. Taking the amount of $4,720 disallowed by the auditors into account (Note (A) to Exhibit D in the auditor's preliminary report), the Hospital owes the property management firm the net amount $10,859.

(SU) 7-9. We agree with the recommendations and the Campus' responses.

(OSC) 10. Determine the amount paid into the capital reserve account and obtain a refund of this amount.

(SUNYSB) 10. As indicated in our response to the preliminary audit findings, the capital reserve account does not belong to the property management firm or to the landlord. The charge of $3,218 was correctly applied in accordance with the lease terms and cannot be credited by either entity. The condominium association develops and controls its own budget, including the Capital Reserve Account, the costs of which are proportioned among the various condominium unit owners. The Capital Reserve Account is a line item in the condominium's budget, not in the landlord's budget. The property management firm does not control the activities of the condominium association. The auditors agree that they have not reviewed the records of the condominium association during the audit to obtain information and supporting documentation of this issue.

(SU) 10. We agree with the Campus' response.

(OSC) 11. Require the entire amount of any CAM overpayment to be applied against the next quarterly billing after the overpayment has been identified.

(SUNYSB) 11. The Hospital will attempt to accelerate the reconciliation process, according to the terms of the leases, so that any overpayment can be obtained in the most current quarter after the reconciliation process.

(OSC) 12. Determine whether the management fees paid to the condominium association and the real estate management firm are at all duplicative, and if so, work to eliminate the duplication.

(SUNYSB) 12. The management fees for L000630 and L000632 will be examined to ensure that the Hospital's proportionate share of the condominium charges are not duplicated in the management fees paid to the owner of the suites leased by the Hospital.

(SU) 11-12. We agree with the recommendations and the Campus' responses.

Renovation Costs (Pg. 12)

Recommendations (Pg. 14)

(OSC) 13. Develop written procedures for lease renovations and ensure that these procedures protect the State's economic interests in the areas of contractor selection, cost estimation, cost monitoring, and cost sharing with the landlord.

(SUNYSB) 13. We will continue our efforts to control renovation costs. Written procedures will be developed to address the areas of contract selection, cost estimation, cost monitoring and cost sharing with the landlord for lease renovations. To the extent that standard business practices and our contractual relationships with the landlord will allow, we will take a more active role in the selection of the construction contractor.

(OSC) 14. Indicate how renovations will be paid for in the price comparisons that accompany the leases submitted for the approval of the Office of the State Comptroller.

(SUNYSB) 14. Future price comparisons submitted to the State Comptroller for leasehold renovations will more clearly outline Hospital and landlord responsibility for renovation costs.

(OSC) 15. Consult with OGS on an ongoing basis as to the reasonableness of proposed lease renovation costs.

(SUNYSB) 15. Although SUNY System Administration, the Attorney General's Office and the State Comptroller reviewed and approved the leases, it was never

recommended to us that the Office of General Services be consulted as well and we were unaware of the advisory services that they offer. In the future we will consider their advisory services as a resource that we may call on as needed during the leasing process.

(SU) 13-15. We agree with the recommendations and the Campus' responses.

State Comptroller's Note

Certain matters addressed in the draft report were revised or deleted in the final report. Therefore, some agency comments included in Appendix B may relate to matters no longer contained in this report.